
April 12, 2004



Acquisition

Small Business Administration
Section 8(a) Program Contracting
Procedures at the Defense Supply
Center, Columbus
(D-2004-070)

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Acronyms

CCPI	Capital City Pipes, Incorporated
DSCC	Defense Supply Center, Columbus
FAR	Federal Acquisition Regulation
SBA	Small Business Administration



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

April 12, 2004

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY, AND LOGISTICS
DIRECTOR, DEFENSE SUPPLY CENTER, COLUMBUS

SUBJECT: Report on Small Business Administration Section 8(a) Program Contracting
Procedures at the Defense Supply Center, Columbus
(Report No. D-2004-070)

We are providing this report for review and comment. We performed the audit in response to a Congressional request. The Under Secretary of Defense for Acquisition, Technology, and Logistics did not respond to the draft report; however, we considered comments from the Defense Logistics Agency when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, we added Recommendation 1.c. to the Under Secretary of Defense for Acquisition, Technology, and Logistics. Therefore, we request that the Under Secretary provide comments on Recommendations 1.a., 1.b. and 1.c. by June 11, 2004.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to Audcm@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Terry L. McKinney at (703) 604-9288 (DSN 664-9288) or Mr. Nick Como at (703) 604-9215 (DSN 664-9215). See Appendix D for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

David K. Steensma
Director
Contract Management Directorate

Office of the Inspector General of the Department of Defense

Report No. D-2004-070

(Project No. D2003CF-0194)

April 12, 2004

Small Business Administration Section 8(a) Program Contracting Procedures at the Defense Supply Center, Columbus

Executive Summary

Who Should Read This Report and Why? DoD contracting activities and DoD Small Business offices should read this report to become fully aware of their roles in the contract administration of the Small Business Administration Minority Small Business and Capital Ownership Development Program and their joint relationships with the Small Business Administration.

Background. The Small Business Administration section 8(a) Business Development Program assists eligible small, disadvantaged businesses compete in the American economy through business development. A small business contractor, J.G.B. Enterprises, alleged to a Congressional Committee that the Small Business Administration and DoD awarded contracts to an ineligible section 8(a) program contractor. The Chairman, Committee on Small Business, U.S. House of Representatives, requested that the Inspector General of the Department of Defense examine whether DoD and the Small Business Administration violated the section 8(a) program of the Small Business Act by awarding contracts to a business that was not financially responsible and that acted as a broker for other manufacturers to perform the requirements.

Results. The primary intention and goal of the Small Business Administration Minority Small Business and Capital Ownership Development Program were not furthered by the administration of the seven contracts cited by the complainant, valued at \$1,502,297. Individually or as a joint effort, the Defense Supply Center, Columbus, Ohio, and the Small Business Administration:

- did not document and support the technical (manufacturing, testing, and delivery) and financial capabilities of the contractor for performing the contract requirements cited in the complaint; and
- did not bar the contractor from fulfilling its contract requirement in a brokering capacity, a prohibited practice for contracting in the Minority Small Business and Capital Ownership Development Program.

As a result of the failure to verify the contractor's capability to perform, the Small Business Administration Minority Small Business and Capital Ownership Development Program diminished its potential to enhance business development as intended while the contractor added no value to the contracts yet earned over \$135,000, or 9 percent of the contract value.

To provide for a more meaningful and effective Minority Small Business and Capital Ownership Development Program, the Under Secretary of Defense for Acquisition,

Technology, and Logistics should require that DoD contracting activities distribute the Partnership Agreement between the Small Business Administration and the Department of Defense, and emphasize compliance with the agreement. In addition, the Under Secretary should require that contracting activities avoid awarding contracts to section 8(a) program contractors who operate as brokers. We added a recommendation to the Under Secretary to define whether the responsibility for determining the technical capability of an 8(a) firm is a DoD responsibility, a Small Business Administration responsibility, or a joint responsibility of DoD and the Small Business Administration. The Director, Defense Supply Center, Columbus should require that its contracting activity and its Small Business Office conduct pre-award surveys of small and disadvantaged businesses when an indication of technical or financial instability exists and require compliance with the Partnership Agreement. (See the Finding section of the report for the detailed recommendations.)

The Chairman, Committee on Small Business request raised two overall issues that pertained to the contractor's financial capability and its performance as a broker. After looking at the complaint, we further defined the issues into five categories: technical capabilities, financial capabilities, required equipment, quality system, and financial statements. The results of our review and the review of the Defense Contract Audit Agency, verified that the contractor did not have financial capability to perform the contracts and the contractor acted as a broker. The review by the Office of the Inspector General, Small Business Administration, determined that the contractor's financial capabilities on two of the three contracts it reviewed were debatable and that the contractor subcontracted all the requirements on at least two contracts. See Appendix C for a discussion of the specific issues raised by the complainant.

Management Comments and Audit Response. We issued a draft of this report on December 12, 2003. The Under Secretary of Defense for Acquisition, Technology, and Logistics did not respond to the draft report. Because of comments received from the Defense Logistics Agency, we added a recommendation to the Under Secretary. Generally, the Defense Logistics Agency contended that DoD does not have a role in determining the technical capability of an 8(a) firm. We believe that the Partnership Agreement between the Small Business Administration and DoD implies a shared responsibility. We request that the Under Secretary of Defense for Acquisition, Technology, and Logistics provide comments to the recommendations in this report by June 11, 2004.

The Deputy Director, Logistics Operations, Defense Logistics Agency, agreed to request preaward surveys of 8(a) firms when the ability of the firm to perform the contract is in question and to revise guidance to alert contracting officers to take additional steps to ensure that 8 (a) firms are responsible and capable of performing. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for complete text of the comments.

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Background

The Chairman, Committee on Small Business, U.S. House of Representatives, requested that the Inspector General Department of Defense (IG DoD) investigate issues raised in a complaint submitted to the Committee. The Committee also tasked the Inspector General for the Small Business Administration (SBA) with the same request. The complainant, J.G.B. Enterprises, contended that the DoD and the SBA violated section 8(a) of the Small Business Act by awarding contracts to a business (Capital Cities Pipes, Incorporated) that was not financially responsible and that acted as a broker for other manufacturers. J.G.B. Enterprises was the manufacturer and subcontractor for seven contracts awarded to the section 8(a) program contractor, Capital City Pipes, Incorporated (CCPI). Specifically, the Committee was concerned that the issues the complainant addressed represented lax oversight by certain officials within the section 8(a) program. The Committee requested a report that would address whether DoD actions were proper and whether we had any recommendation that might strengthen oversight of the section 8(a) program.

Small Business Administration Minority Small Business and Capital Ownership Development Program. Title 13, Code of Federal Regulations, Part 124, “8(a) Business Development/ Small Disadvantaged Business Status Determination,” Chapter 1, Subpart A – 8(a) Business Development, January 1, 2002, addresses the SBA management of the section 8(a) Business Development Program. The intention and goal of the section 8(a) Business Development Program is to assist eligible small, disadvantaged businesses compete in the American economy through business development. The businesses are eligible for the program based on size, social and economic disadvantage, character, and potential to succeed. The SBA determines whether a business will receive admission into the program. The business must remain eligible and must submit required information annually to the SBA. A business can participate in the section 8(a) program for 9 years from the date of the SBA approval letter that certifies the business’s admission into the program. The SBA Division of Program Certification and Eligibility field office serving the territory in which the principal place of business is located accepts applications for admission into the section 8(a) program.

Wholesalers Versus Brokers. Title 13 also contrasts eligibility requirements for section 8(a) program contractors whose business operations parallel those of a wholesaler versus a broker. Wholesalers can seek admission into the section 8(a) program and do not need to demonstrate that they are capable of meeting the requirements of the nonmanufacturer rule for its primary industry classification. The nonmanufacturer rule requires that a section 8(a) program contractor provide either its own product or that of another domestic small business manufacturing or processing concern. However, “brokers” are ineligible to participate in the section 8(a) program. Title 13 defines a broker as a “. . . concern that adds no material value to an item or possession of or handle the item being procured with its own equipment or facilities.”

Standard Industrial Classification Codes. The Standard Industrial Classification System (referred to as the North American Industry Classification System) is a Department of Commerce-managed standardized classification system established on an industry-by-industry basis covering the entire field of

U.S. economic activity. The SBA uses that system to determine whether an eligible small business is qualified to participate in the manufacture of a specific type of product line or to provide a specific service. The classification system includes products made or services rendered in the industry that best fit the principal nature of the small business contract.

Memorandum of Understanding. In March 1998 a “Memorandum of Understanding between the U.S. Small Business Administration and the U.S. Department of Defense” was signed with the primary objective of expediting and streamlining the time intervals for offering to and determining eligibility of section 8(a) program contractors for DoD awards. The memorandum defined the agencies’ responsibilities for the administration of the section 8(a) program and provisions for the measure of its effectiveness. Specifically, the memorandum permitted that the SBA and DoD jointly address the capability of a section 8(a) program contractor. The SBA retained the right to perform on-site contract surveillance reviews and the responsibility for compliance with all provisions of title 13, including determining section 8(a) program contractor eligibility. DoD was responsible for determining which requirements were suitable to be offered to the section 8(a) program in accordance with the Federal Acquisition Regulations (FAR) Subpart 19.8. Where appropriate, DoD identified in conjunction with the appropriate SBA servicing offices section 8(a) program participants capable of performing the requirements. DoD continued to be responsible for complying with any applicable provisions of the FAR and the Defense Supplement. In 2002, the Memorandum of Understanding was superseded by a “Partnership Agreement between the U.S. Small Business Administration and the Department of Defense.”

Federal Acquisition Regulation Requirements. FAR Part 19, Small Business Programs, addresses the overall policy, eligibility requirements, and coordinating roles of DoD and the SBA for the section 8(a) program. The policy mandates the maximum practicable opportunities in Government acquisitions to small, disadvantaged business concerns. FAR Part 19 does not specifically cite the Memorandum of Understanding or the Partnership Agreement nor does it reference or prohibit brokering or broker participation in the section 8(a) program. Part 19 does, however, permit the contracting officer to request a pre-award survey whenever considered useful. If the results of the pre-award survey raise substantial doubt as to the section 8(a) program contractor’s ability to perform, the contracting officer must refer the matter to the SBA for certificate of competency consideration.

Objective

The audit objective was to examine procedures the DoD acquisition officials used to determine Small Business section 8(a) program contractor capabilities to manufacture and deliver items specified in the contracts. See Appendix A for a discussion of the audit scope and methodology.

Section 8(a) Program Contracting Procedures

The procedures DoD acquisition officials and the SBA used for determining a Small Business section 8(a) Business Development program contractor capabilities to manufacture and deliver items specified in the seven contracts, valued at \$1,502,297, were inadequate, and the primary intentions and goals of the SBA Minority Small Business and Capital Ownership Development Program were not served. The SBA and the Defense Supply Center, Columbus (DSCC) did not document and support the technical and financial capability of the section 8(a) program contractor for performing the contract requirements and permitted the section 8(a) program contractor to perform the contract requirements as a broker, which is a practice that the SBA prohibits. As a result, the SBA Minority Small Business and Capital Ownership Development Program diminished its potential for enhancing business development as intended. In addition, the section 8(a) program contractor earned over \$135,700 while adding no value to the contracts DSCC awarded.

Certification and Acceptance into the Section 8(a) Program

Section 8(a) Program Contractor Certification Procedures. The SBA certifies to DoD that a section 8(a) program contractor is competent and responsible to perform a specific contract and authorizes the contracting officer to award the contract based on mutually agreeable terms and conditions. The SBA and DoD, through cooperative efforts, match the DoD requirements with the capabilities of section 8(a) program concerns to establish a basis for contracting with the SBA under the section 8(a) program. The section 8(a) program contractor selection methods are:

- the SBA advises the DoD contracting activity through a search letter identifying the capabilities of a section 8(a) program firm and asks that DoD identify acquisitions to support the firm's business plans,
- the SBA identifies a specific requirement for a particular section 8(a) program firm and asks that the DoD contracting activity offer an acquisition to the section 8(a) program for the firms, or
- DoD reviews the proposed acquisitions and identifies requirements for SBA.

Section 8(a) Program Contractor Acceptance Procedures. The DoD contracting activity must notify the SBA of its plans to place section 8(a) program contracts for specific quantities of items or specific types of work. The notification must identify information such as the description of the work, the period of performance, the applicable North American Industry Classification System code (formerly Standard Industrial Classification code), an anticipated dollar value, the capabilities needed, the type of contract anticipated, and the history of the acquisition. Once the offer is received, the SBA determines whether to accept the requirements of the offer. If it accepts the acquisition as a

sole-source contract, the SBA will advise the contracting activity of the section 8(a) program firm selected. The SBA reviews the appropriateness of the designated industry classification code assigned to the requirement by the DoD contracting activity. The contracting officer requests a pre-award survey of the contractor whenever the contracting officer considers it useful. If the results of the pre-award survey raise any substantial doubt as to the ability of the firm to perform, the contracting officer must refer the matter to the SBA for a Certificate of Competency. DoD contracting activities cannot award a section 8(a) program contract if the price of the contract results in a cost that exceeds a fair market price.

Defense Logistics Agency Instruction 9100.1. The Defense Logistics Agency Instruction 9100.1, “DLA Office of Small and Disadvantaged Business Programs,” February 17, 1999, provides guidance for the small business specialists of a DoD procurement activity. The instruction empowers small business specialists to assist contracting officers target procurements for the section 8(a) program, work with contracting officers and match qualified section 8(a) program businesses with potential procurement opportunities, and assist the section 8(a) program businesses identify potential procurement opportunities. The instruction specifically permits the small business specialist to seek potential section 8(a) program companies whose manufactured products or rendered services match the needs of DoD procurement.

Contracts Awarded to Capital City Pipes, Inc.

The procedures DoD and SBA used for determining the capabilities of section 8(a) program contractors to manufacture and deliver items specified in the contracts awarded to CCPI were inadequate. DSCC awarded CCPI with the seven contracts cited in the complaint, collectively valued at \$1,502,297, while aware that CCPI would subcontract the contract requirements. The complainant, J.G.B. Enterprises, manufactured, tested, packaged, and delivered all items procured in the seven contracts. CCPI performed only administrative functions for managing the contracts between J.G.B. Enterprises and DSCC. Furthermore, CCPI did not stock or maintain the contracted items. DSCC officials confirmed that subcontracting was a practice that was permitted and one that section 8(a) program contractors used often. However, the CCPI contracting actions parallel those of brokering because CCPI did not handle the procured item with its own equipment or facilities yet earned 9 percent of the contract value.

Confirming Contractor Technical Capability

Technical Capability. SBA and DSCC did not document and support the technical capabilities of CCPI for manufacturing the hose assemblies purchased in the seven contracts. DSCC provided SBA with a formal offering letter for the seven contracts cited in the complaint. SBA subsequently responded with a letter of acceptance stating that CCPI had “the requisite capabilities” to perform the requirements. DSCC Small Business and contracting officials stated that DSCC accepted the letters without question or challenge and awarded the seven contracts to CCPI.

Other than the SBA acceptance letter, we did not find any evidence in the contract file or in discussion with the contracting officers that proved SBA unilaterally conducted an analysis that would determine the capability of CCPI to perform. In addition, representatives of the SBA Office of the Inspector General informed us that, according to an 8(a) official, the 8(a) program officials are not supposed to determine whether the contractor has the ability to complete the proposed contract. The 8(a) official further stated that the SBA 8(a) employees accepting contracts into the 8(a) program are not required to have the technical expertise to determine whether a contractor has technical manufacturing capability for a particular contract award.

The contracting officials stated that the DSCC Small Business Office strongly influenced the contracting activity to award contracts to section 8(a) program contractors in an effort to meet DoD goals for small and disadvantaged businesses. While attempting to meet those goals, the DSCC Small Business Office and the contracting activities made no effort to validate contractor capabilities. Because the CCPI business consisted of a wholesaler that primarily distributed pipes, valve fittings, and pumps, the business was not capable of constructing the five highly technical hose assemblies for use on military aircraft and ground vehicles. A pre-award survey, performed by the Defense Contract Management Command (now the Defense Contract Management Agency [DCMA]), Clearwater, Florida, recognized the capability of CCPI to “flow down” the requirements to their suppliers and to provide the management and administrative support required for successfully managing the contract as a wholesaler. The pre-award survey described responsibilities in the contract as wholesaler functions.

CCPI subcontracted the entire contract manufacturing, testing, packaging, and delivery requirements to capable contractors. CCPI did not add any material value to the item or handle the item with its own equipment or facilities. Although normal business activity of CCPI constitutes that of a wholesaler, its activity in the contracts clearly defines functions associated with brokering.

Agreements between SBA and DoD. The 1998 Memorandum of Understanding permitted DoD to coordinate with the SBA servicing offices to validate whether the section 8(a) program contractor was capable of performing specific contract requirements. The Partnership Agreement replaced and paralleled the Memorandum of Understanding by addressing DoD responsibility for validating section 8(a) program contractors’ capabilities. The contracting activity at DSCC was not aware of the Memorandum of Understanding or the Partnership Agreement and a copy of neither was available at DSCC. The documents had not been distributed to the field activities. Instead, DSCC relied solely on the SBA acceptance letter for determining whether CCPI was capable of performing the awarded contracts.

Confirming Contractor Financial Capability

The SBA Inspector General found that SBA did not obtain mandatory financial statements from CCPI to adequately judge financial capability of CCPI. Before the award of the third contract in June 1999, an indication existed of unstable financial condition of CCPI. The pre-award survey, conducted by the Defense

Contract Management Command, also stated that financial condition of CCPI was unsatisfactory and could not be rated as favorable because of unaudited financial statements, negative measures of liquidity, a low cash position of assets, and a high accounts payable balance. After that indication of unsatisfactory financial condition, DSCC did not pursue its right to request a Certificate of Competency from the SBA. A Certificate of Competency ensures that a contractor is responsible in the areas of capability, competency, credit, and integrity for receiving and performing a specific Government contract. DSCC officials stated that it would be less likely to perform the review to support a Certificate of Competency because SBA had already issued acceptance letters for CCPI. DSCC awarded 10 additional contracts to CCPI subsequent to receiving an indication that CCPI was having financial difficulties.

The SBA Inspector General reported that CCPI did not submit required financial statements to the SBA. The Defense Contract Audit Agency reported in November 2000 that CCPI had experienced financial instability since 1997. Determining the financial capabilities of CCPI is not possible without reviewing the financial statements, which would have indicated financial problems.

CCPI Dual Standard Industrial Code Classifications.

CCPI was qualified under two Standard Industrial Classification code groups: group 34—manufacture of fabricated metal products, and group 50—wholesale trade-durable goods. Within group 34, CCPI was specifically qualified for the manufacture of “valves and pipe fittings” (code 3494). Within group 50, CCPI was specifically qualified in the wholesale business capacity for the sale of “industrial machinery and equipment” (code 5084). The 5084 Standard Industrial Code signified that CCPI was qualified as a wholesaler, a dealer, or a distributor—business functions that the DSCC Small Business Office used interchangeably. The DSCC Small Business Office representative stated that the SBA also qualified CCPI with a manufacturer classification to maintain “congruency” with the contract solicitations because DSCC would not want to solicit only to dealers.

The SBA acknowledged that CCPI was qualified for both the 3494 and 5084 classification codes in each of the seven contract actions cited by the complainant. The SBA Inspector General found that the SBA did not always obtain or necessarily review the contract document. However, SBA should have been aware that, as a wholesaler, CCPI was limited to providing only the materials for assembly, a wholesale function. CCPI did not function as a wholesaler in the seven contract actions but acted as a broker by subcontracting the entire manufacturing, testing, packaging, and shipping functions for the seven contract actions to other businesses.

Conclusion

The primary goal of the Minority Small Business and Capital Ownership Development Program is to assist the entry of small disadvantaged businesses into the mainstream of DoD procurement by gaining access to the resources necessary for improving a firm's opportunities and competing on an equal basis. The business practices that CCPI perpetuated in the seven contracts did not improve its opportunity to compete with established firms in the manufacture of hose assemblies. Subcontracting the entire contract requirement merely allowed CCPI to gain a percentage of the selling price. We question the merit of enhancing small and disadvantaged businesses by supporting a contractor who can only fulfill contract requirements in a brokering capacity.

The contracting officers and Small Business Office officials at DSCC did not fully implement contract administration procedures that would determine the capability of a section 8(a) program contractor. The contracting officers and Small Business Office officials relied solely on the SBA for determining contractor capability. The SBA Inspector General stated that the SBA field office was aware but did not take appropriate action on at least one contract that the contractor improperly fulfilled the contractor requirements within the SBA definition of broker. Contracting officers and Small Business Office officials were unaware of their responsibilities addressed in the Memorandum of Understanding, which further exacerbated any attempt to validate the capabilities of the contractor.

We cannot estimate within the DoD contracting community the pervasiveness of the weaknesses of the joint contract administration addressed in this report and realize that the issues raised involve one section 8(a) program contractor, one DoD contracting activity, and seven contract actions. DoD contracting activities should, however, be aware of their duties and responsibilities outlined in the current Partnership Agreement and realize the possibility that SBA may be providing less than satisfactory compliance with its own internal contract administration procedures of the Minority Small Business and Capital Ownership Development Program.

Recommendations, Management Comments, and Audit Response

Management Comments Required and Added Recommendations. The Under Secretary of Defense for Acquisition, Technology, and Logistics did not comment on Recommendations 1.a. and 1.b on a draft of this report. In addition, because of comments provided by the Defense Logistics Agency to the finding of this report, we added Recommendation 1.c. to the Under Secretary to clarify responsibilities between DoD and the SBA on determining the technical capability of an 8(a) contractor. We request that the Under Secretary of Defense for Acquisition, Technology, and Logistics provide comments to Recommendations 1.a., 1.b., and 1.c., in response to the final report.

1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics:

- a. Distribute the Partnership Agreement between the Small Business Administration and the Department of Defense to all contracting offices and emphasize compliance with the Agreement.**
- b. Provide guidance about awarding contracts to those Small and Disadvantaged Businesses whose only role in the contract requirement parallel those of broker, defined as a prohibitive practice in the Code of Federal Regulations, Title13, Part 124.**
- c. Define whether the responsibility for determining the technical capability of an 8(a) firm is a sole DoD or Small Business Administration responsibility or a joint responsibility between both organizations.**

2. We recommend that the Director, Defense Supply Center, Columbus require its contracting activity and Small Business Office to:

- a. Conduct a pre-award survey of a Small and Disadvantaged Business when evident that the contractor may be experiencing technical or financial instability that would affect successful contract completion.**

Management Comments. The Deputy Director, Logistics Operations, Defense Logistics Agency concurred with the Recommendation that was directed to the Director, Defense Supply Center, Columbus. The Deputy Director stated that a pre-award survey will be requested when the ability of an 8(a) firm to perform the contract is questioned. The Defense Supply Center, Columbus added language requiring pre-award surveys into their acquisition guidance. Similar guidance is being prepared and will be incorporated into the Defense Logistics Agency acquisition directive.

- b. Comply with provisions of the Partnership Agreement between the Small Business Administration and the Department of Defense.**

Management Comments. The Deputy Director concurred with the recommendation and stated that the Defense Supply Center Columbus revised its acquisition guidance in September 2003, to alert contracting officers to take additional steps to ensure that 8(a) firms are responsible and capable of performing. In addition, the acquisition directive is being revised accordingly.

Management Comments on the Finding and Audit Response

The Deputy Director, Logistics Operations, Defense Logistics Agency provided the following comments to the finding. For a full text of the Defense Logistics Agency comments, see the Management Comments section of the report.

Defense Logistics Agency Comments. The Deputy Director contended that the draft report indicated that the MOU and subsequent Partnership Agreement either completely shifted to DoD or established shared responsibilities between DoD and the SBA for determining the technical capability of an 8(a) firm. These agreements permit, but not require, DoD to address the capability of an 8(a) firm and does not relieve SBA of that responsibility. Because the SBA remains the prime contractor in an 8(a) contract award, the determination of technical capability of an 8(a) firm remains an SBA function. The Defense Supply Center should have requested a Certificate of Competency from the SBA when the pre-award survey indicated that the subject 8(a) firm experienced financial difficulties.

Audit Response. We contend that the current partnership agreement in effect between the SBA and the DoD does not unilaterally shift the responsibility for determining the technical capabilities of an 8(a) firm to the DoD but does permit the sharing of such responsibilities between the organizations. Section IV.b.2. of the Partnership Agreement states that:

The Department of Defense shall determine which requirements are suitable for offering to the 8(a) program in accordance with FAR Subpart 19.8, and, where appropriate, identify, in conjunction with the appropriate SBA servicing offices, 8(a) participants capable of performing these requirements.

As written, the coordinated effort outlined in the agreement does not suggest that the SBA was relieved of determining whether an 8(a) firm is capable of performing contract requirements. However, the agreement permits DoD to take an active role to confirm the technical capability of an 8(a) firm. In addition, FAR Subsection 19.804-1 permits DoD to obtain "...any other pertinent information about known 8(a) contractors, the items, or the work. This includes any information concerning the firms' capabilities. When necessary, the contracting agency shall make an independent review of the factors in 19.803(a) [including information pertaining to the concern's technical ability and capacity to perform] and other aspects of the firms' capabilities which would ensure the satisfactory performance of the requirement being considered for commitment to the 8(a) Program."

We also received written correspondence from the SBA Inspector General's Office that opposed the position of the Defense Logistics Agency regarding the determination of the technical capability of an 8(a) firm. In a March 15, 2004 memorandum, the SBA Inspector General's Office stated that, "According to an [SBA] 8(a) official, SBA is responsible for determining that the company is eligible for the 8(a) program, not whether it has the financial ability or the technical capability to do the contract."

A conflict involving the interpretation and perception of the Partnership Agreement exists between DoD and the SBA when addressing responsibilities for determining the technical capability of an 8(a) firm. A formal clarification of the duties and responsibilities between the two organizations is recommended, therefore, we have added Recommendation 1.c. to the Under Secretary of Defense for Acquisition, Technology, and Logistics to the final report.

Appendix A. Scope and Methodology

Work Performed. We reviewed issues raised in a complaint submitted to the Chairman, Committee on Small Business, U.S. House of Representatives, regarding whether DoD violated section 8(a) of the Small Business Act by awarding contracts to a business that was not technically capable or financially responsible. See Appendix C for the overall issues raised by the complainant and our conclusions.

We visited contract and Small Business Office personnel at the DSCC. We also met with representatives of the Office of the Inspector General, SBA, to discuss issues in the congressional request that addressed the SBA contract administrative procedures.

We analyzed the actions and related modifications on seven contracts, collectively valued at \$1,502,297, for the procurement of various hose assemblies. We also analyzed documents in the seven contract files, including memorandums and correspondence between the following organizations and personnel: SBA; CCPI; J.G.B. Enterprises; DSCC contract and Small Business Office personnel; and the Defense Finance and Accounting Center, Columbus. The documents are dated between August 1998 and September 2000.

We performed this audit from August 2003 through December 2003 in accordance with generally accepted government auditing standards. We did not review the management control program because of the limited scope of this audit. The Committee on Small Business, U.S. House of Representatives, requested that we determine whether DoD and SBA violated section 8(a) of the Small Business Act. We reviewed the DoD role in the contracting actions and responded to the overall issues raised by the complainant.

Use of Computer-Processed Data. We did not use computer-processed data to perform this audit.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Contract Management (Improve Processes and Controls to Reduce Contract Risk) high-risk area.

Prior Coverage

During the last 5 years, the Defense Contract Audit Agency and the U.S. Small Business Administration Inspector General have issued two reports related to the financial stability of CCPI.

Defense Contract Audit Agency Report No. 1301-2000N17600113, "Audit of Financial Capability," November 15, 2000

SBA Office of the Inspector General Memorandum (untitled), September 5, 2003

Appendix B. Congressional Request

Congress of the United States

House of Representatives

108th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6315

July 25, 2003

VIA FACSIMILE AND FIRST CLASS MAIL

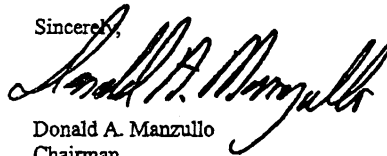
The Honorable Joseph Schmitz
Inspector General
United States Department of Defense
400 Army-Navy Drive, Suite 1000
Arlington, VA 20301

Dear Inspector General Schmitz:

The Committee has been contacted by J.G.B. Enterprises, a small business that believes the Department of Defense and the Small Business Administration violated section 8(a) of the Small Business Act by: 1) awarding a contract to a business that was not financially responsible under § 8(a) of the Small Business Act; and 2) did not manufacture the goods itself but acted as a broker for other manufacturers. The Committee is concerned that the issues addressed in the enclosed facsimile from J.G.B. Enterprises represents lax oversight by certain officials within the 8(a) program.

Please investigate the issues raised in the enclosed facsimile within two weeks of receipt of this letter and report back to the Committee. A copy of this material has previously been delivered to the Small Business Administration's Inspector General. The report should address whether the actions by Department of Defense officials were proper and any recommendations that might strengthen oversight of 8(a) contractors by the Department. Should your staff have any questions concerning this letter, please have your staff contact Barry Pineles, Regulatory Counsel to the Committee on Small Business at 202-225-5821.

Sincerely,



Donald A. Manzullo
Chairman

Enclosure

Appendix C. Responses to Issues Raised in the Congressional Complaint

Issue 1. Technical Capability

The complainant alleged that CCPI did not have the technical or management competencies for performing the contract requirements and violated regulations by subcontracting the entire contract effort. The complainant further alleged that a contract stated inspection and acceptance would occur at the subcontractor facility, thus proving that the prime contractor did not have the capability.

Audit Results. The allegations made by the complainant are true. CCPI did not have the technical competency to perform the manufacturing requirements in the contract. However, the SBA qualified CCPI as a wholesaler under the Standard Industrial Classification. Therefore, per its industrial classification of a wholesaler, CCPI was not required to demonstrate that it was capable of meeting the manufacturing requirements. CCPI needed only to demonstrate capability for performing wholesale functions, such as ensuring the subcontractor obtained the material according to specifications and that the items were properly tested, packaged, and shipped. The Defense Contract Management Command reviewed the technical capability of CCPI and found that CCPI demonstrated “. . . satisfactory capability to ‘flow down’ the contract requirements to their suppliers and to provide the management and administrative support required to successfully manage the contract as a wholesaler.” A DSCC official stated that because CCPI was qualified as a wholesaler for the seven contracts, it did not violate regulations by subcontracting the contract requirements. Finally, the inspection and acceptance of the items in the contract would occur at the facility that manufactured the items.

Issue 2. Manufacturing, Testing, or Measuring Equipment

The complainant alleged that, “CCPI had no manufacturing, test or measurement equipment to perform the contracts.”

Audit Results. The allegation made by the complainant is true. CCPI did not have the manufacturing, test, or measurement equipment necessary for the technical aspect required in the contracts. However, SBA qualified CCPI as both a wholesaler and a manufacturer. The industry classification for CCPI and its role as a wholesaler precluded the necessity for the specialized equipment for manufacturing, testing, or measuring. The contracts indicated that manufacture, inspection, and packaging of the items would occur at the manufacturer’s facility.

Issue 3. Quality System

The complainant alleged that, “CCPI had no government approved Quality System in place as required by the section 8(a) program.” The complainant further alleged that, “all contracts sole sourced to CCPI by DSCC required adherence to MIL-Specs (military specifications) for procurement, record keeping, manufacturing, process control, testing and quality control. CCPI did not have the inherent ability to comply with any of these specifications.”

Audit Results. The allegation made by the complainant is true. CCPI did not have a Government-approved quality system in place. As the SBA qualified CCPI as a wholesaler, a quality system associated with manufacturing processes would not be required for a wholesaler.

Issue 4. Financial Stability

The complainant alleged that, “CCPI had significant financial instability.” The complainant further alleged that, “At the time the SBA certifies their finances, CCPI is incurring substantial debts” and that a Defense Contract Audit Agency audit report shows that CCPI was an insolvent company. Regarding financial issues, the complainant further alleged that, “someone at DSCC unilaterally modified the contract without J.G.B. Enterprise’s knowledge and CCPI received the payment for the contract.”

Audit Results. Regarding the financial instability of CCPI, the allegation is true. CCPI was not financially stable. We reviewed contract files and a pre-award survey that disclosed that CCPI was experiencing financial problems. DSCC subsequently awarded 10 contracts, valued at \$624,569 to CCPI after obtaining knowledge of financial instability of CCPI. A DSCC Small Business official stated that because the CCPI role in the contracts consisted of primarily handling the administrative aspects of the contracts, DSCC officials continued to award contracts to CCPI in an attempt to aid in financial recovery of CCPI. DSCC incurred unnecessary risk by continuing to award contracts to a contractor who was not financially stable.

The Defense Contract Audit Agency report, November 2000, reflects severe financial instability for CCPI. However, DSCC did not award any contracts to CCPI subsequent to the date of the Defense Contract Audit Agency report.

Regarding the complainant’s payment issue, the allegation is not true. DSCC never modified the payment address for remitting payment to any contractor other than CCPI. Upon the complainant’s request for payment redirection, DSCC denied it and informed the complainant that the Government is obligated to make payment to only the prime contractor.

Issue 5: Financial Statements and Business Plans

The complainant alleged that, “CCPI failed to file mandatory audited financial statements and business plans as required.”

Audit Results. This allegation is true. The SBA Inspector General addressed this issue and reported that CCPI had not submitted required financial statements. The SBA Inspector General also reported that the SBA inappropriately accepted procurements, as CCPI was noncompliant with the SBA regulations because it did not submit the required financial statements. Because the Defense Contract Audit Agency reported that CCPI had experienced financial instability since 1997, timely submission of the required financial statements would have disclosed the financial difficulties. The SBA could not have informed DSCC of the financial instability of CCPI without requiring proper submission of financial statements.

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Under Secretary of Defense for Acquisition, Technology, and Logistics
Director, Defense Procurement and Acquisition Policy
Director, Office of Small and Disadvantaged Business Utilization

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Combatant Command

Inspector General, U.S. Joint Forces Command

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Contract Management Agency
Director, Defense Logistics Agency
Director, Defense Supply Center Columbus

Non-Defense Federal Organization

Director, Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform
House Committee on Small Business

Defense Logistics Agency Comments



REPLY
REFER TO J-3

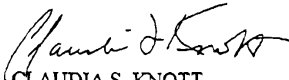
DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

MAR 18 2004

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: Small Business Administration Section 8(a) Program Contracting Procedures at the
Defense Supply Center, Columbus (Project No. D2003CF-0194)

This is in response to the subject draft report dated December 12, 2003. If you have any
questions, please contact Mrs. Peggy Hayes, (703) 767-6262.


CLAUDIA S. KNOTT
Deputy Director
Logistics Operations

Encl

SUBJECT: Department of Defense Inspector General (DOD-IG) Draft Report, "Small Business Administration (SBA) Section 8(a) Program Contracting Procedures at the Defense Supply Center Columbus (DSCC)" (Project No. D2003CF-0194)

The objective of the subject draft DOD-IG report was to determine whether the DOD and the SBA violated the section 8(a) program of the Small Business Act by awarding contracts to a business that was not financially responsible and acted as a broker for other manufacturers to perform the requirements. The DOD-IG report was undertaken at the request of the Chairman, Committee on Small Business, U.S. House of Representatives.

The DSCC response requested by the DOD-IG has been incorporated into our response. The Defense Logistics Agency (DLA) concurs with the DOD-IG recommendations, but would like to offer the following comments on the report. As described below, DSCC has taken actions to strengthen their oversight of the 8(a) Program participants with whom they do business.

Finding: The procedures DOD acquisition officials and the SBA used for determining a Small Business section 8(a) Program contractor capable to manufacture and deliver items in accordance with contractual requirements were inadequate, and the primary intentions and goals of the SBA 8(a) Program were not served.

Nonconcur with the finding as it pertains to DOD. The draft report seems to indicate that either the 1998 Memorandum of Understanding (MOU) between the SBA and DOD or the subsequent 2002 Partnership Agreement (PA) shifted responsibilities to the DOD procuring activity, or that the responsibilities of both became joint and equal. The basic purpose of these agreements is to permit the DOD activity to sign a contract with the 8(a) concern; the SBA remains the prime contractor and continues to determine the eligibility of concerns for award. Furthermore, the MOU and PA merely permit the DOD activity to address the capability of a program participant; they do not require DOD to do so, nor does DOD's involvement, whatever its level, relieve SBA of its fundamental duty. (Please note that if passed, Section 208 of the Small Business Reauthorization Act, H. R. 2802, currently under consideration, could eliminate the right of procurement activities to deal directly with the 8(a) firms, in effect requiring the cancellation of the current PA.)

With regard to the contracts at issue in the draft report, SBA informed DLA that Capital City Pipes, Inc (CCPI) had the "requisite capabilities" to perform the requirements identified by DSCC. Moreover, CCPI was characterized by the SBA as a wholesaler, not a broker. DSCC took an additional step of calling for a preaward survey on CCPI; that survey indicated that CCPI had the ability to "flow down" requirements to subcontractors and to function as a wholesaler. Since the preaward survey did not raise a red flag regarding ~~CCPI's capabilities as a wholesaler,~~

and SBA had initially characterized the firm as a wholesaler, DSCC relied on these determinations.

Although the contractor did perform satisfactorily on all seven contracts, DSCC should have requested a Certificate of Competency from the SBA when the preaward survey in the 1999-2000 timeframe indicated CCPI's having financial difficulties. However, as the draft report acknowledges, DSCC did not make additional awards to CCPI following a negative audit report by the Defense Contract Audit Agency in November 2000. We note that although the Federal Acquisition Regulation (FAR) Section 19.809 permits the contracting officer to request a preaward survey whenever useful, it may be helpful to put this guidance into the Defense FAR Supplement (DFARS) Subpart 19.8 procedures, since FAR 19.800(f) directs contracting officers to DFARS for guidance where the SBA has delegated its 8(a) program contract execution authority.

DLA defers to the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics with regard to the draft DOD-IG's Report Recommendations 1.a. and 1.b. Our response to Recommendations 2.a. and 2.b is as follows:

Recommendation 2.a.: Recommend that the DSCC contracting activity and the Small Business Office conduct a preaward survey of a Small and Disadvantaged Business when evident that the contractor may be experiencing technical or financial instability that would affect successful contract completion.

Concur. DLA concurs in the recommendation to request that a preaward survey be conducted whenever there is a question of a concern's ability to perform the contract. DSCC inserted language requiring preaward surveys on 8(a) firms, as on non-8(a) firms, into their DSCC Acquisition Guidance (DAG). That publication also directs the contracting officer to request a Certificate of Competency from the SBA if he or she makes an independent determination of an 8(a)'s firm nonresponsibility. Similar guidance is being drafted and will be incorporated into the DLA Acquisition Directive.

Recommendation 2.b.: Recommend that the DSCC contracting activity and the Small Business Office comply with provisions of the Partnership Agreement between the SBA and the DOD.

Concur. As noted in the response to Recommendation 2.a., the DAG was revised last September to alert contracting officers to take additional steps to ensure that 8(a) concerns with whom they propose to contract are responsible and capable of performing, and the DIAD is being revised accordingly. The 8(a) responsibility situation was discussed in the DSCC Acquisition Council held on October 2, 2003, and included in the minutes of the meeting. These minutes were published and set forth in the Acquisition Folder contained on the share drive on each DSCC employee's desktop. A "Message of the Day" on this subject was issued to the DSCC Acquisition workforce on October 3, 2003.

Questions on the above may be directed to my action officer, Ms. Mary Massaro, at (703) 767-1366 (DSN 427-1366), or by e-mail addressed to Mary.Massaro@dia.mil.



KATHY D. CUTLER
Executive Director
Acquisition, Technical and Supply Directorate

Team Members

The Contract Management Directorate, Office of the Deputy Inspector General for Auditing of the Department of Defense prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

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